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Upstarts vs. Big Tobacco

Small cigarette makers defend escrow loophole

By **Stephanie Stoughton**
Associated Press

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RICHMOND, Va. — Little Tobacco is preparing to fight Big Tobacco in Virginia and other states considering legislation that could sap the small manufacturers' sales.

The dispute emerged from a landmark national settlement that required Philip Morris USA and other industry giants to pay \$206 billion to settle lawsuits by the states over health-care costs. Last year Kentucky became one of 37 states to pass a law closing a loophole in the settlement that benefits smaller cigarette makers.

Major tobacco companies and the National Association of Attorneys General say that loophole gives an unfair price advantage to smaller manufacturers operating outside the 1998 agreement. But the smaller companies counter that the states are unfairly seeking to punish them for the larger companies' past behavior — and perhaps snuff them out.

"The attorneys general are supposed to be representing all of us," said Everett Gee, general counsel for S&M Brands, the Keysville, Va., maker of Bailey's cigarettes. "But clearly, the states are in bed with Big Tobacco."

In recent years, Little Tobacco's protests barely registered as statehouse after statehouse passed legislation to close the loophole. The legislation forced many small cigarette makers to raise prices.

Lobbyists for the companies realized it was almost impossible to match the clout of the industry giants and the attorneys general, who had urged the states to deal with Little Tobacco's growth.

In Delaware, for example, lobbyists for the small manufacturers thought they had defeated the measure.



BY STEVE HELBER/ASSOCIATED PRESS

Makers of discount cigarettes, such as these from S&M Brands, say states are unfairly seeking to punish them.

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But "it reappeared the last day of the session, four minutes past 12 at night, when our lobbyist was in bed," said Ron Tully, chairman of the Council of Independent Tobacco Manufacturers.

Last April, Kentucky's General Assembly approved a measure that lets the state keep any excess payments made by tobacco companies not participating in the Master Settlement Agreement in escrow for 25 years. In September, three companies asked a federal judge in Lexington to stop Kentucky from enforcing the law, claiming it is unconstitutional and violates federal antitrust laws.

The Kentucky lawsuit was filed a week after a New York judge said that state could not enforce a similar statute. The defendants named in the Kentucky suit are Attorney General Greg Stumbo and Mark Treesh, Kentucky's commissioner of revenue. The suit is pending.

Before Kentucky's new law, companies that had not signed the agreement would receive refunds on the escrow payments, minus a state share of about 6.8 cents per carton sold. Those companies have to pay almost \$4 per carton into escrow.

Many people are familiar with the basics of the Master Settlement Agreement, which required Philip Morris, R.J. Reynolds, Brown & Williamson (the former Louisville company that has since merged with RJR to form Reynolds American) and Lorillard to make large payments to the states. The companies passed on the costs to smokers by raising prices.

Lesser known are the settlement's complex rules.

Philip Morris and the other companies, for instance, make payments that are allocated to the states based on a formula. Kentucky, for example, gets about 2 percent of the funds, while states like New York and California each get about 13 percent.

To keep smaller manufacturers from getting a price advantage, the states passed statutes requiring them to deposit money into escrow in each state where they do business. The money would be returned in 25 years if there were no liabilities from tobacco-related claims.

But the statutes also allowed the little guys to quickly recover part of their money if the amount they paid to a particular state exceeded what they would have paid had they joined the settlement. Thus, companies that concentrated their sales in states like Wyoming and Idaho — which receive tiny shares of MSA payments — could recoup much of their escrow funds and then under-price the major firms.

The nonparticipating manufacturers were able to grow their market share from less than 1 percent before the settlement to more than 8 percent in 2003, according to a report by PricewaterhouseCoopers.

Alarmed by the trend, the attorneys general association in the fall of 2003 warned the states to

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expect a large decline in settlement payments. It also urged the states to target nonparticipating manufacturers' sales by adopting several measures, including the amendment that closed the so-called loophole in the escrow statute.

The nonparticipating manufacturers have made some progress by suing states and by lobbying heavily in other states that have yet to pass the legislation.

Following on the Kentucky suit, Xcaliber International Ltd. and KT&G Corp. filed a complaint last month in Oklahoma seeking to block that state from enforcing an amendment they say violates antitrust law. A federal judge agreed to a temporary restraining order until a hearing this month.

The small tobacco companies hope the court cases will make politicians in Virginia and elsewhere more cautious about supporting the amendment. Other states that haven't passed the measure are North Carolina, South Carolina, Arkansas, Kansas, Missouri, Nevada, New Jersey and North Dakota.

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